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PROPOSALS AND ISSUES RELATING TO THE PORTABILITY OF PENSION PLAN BENEFITS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

ON JULY 12, 1988

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OF THE

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of the issues and legislative proposals relating to the portability of pension plan benefits.

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a hearing on July 12, 1988, which will focus on the components of pension benefit losses due to employment mobility and current proposals to limit such losses.

Part I of the pamphlet is an overview. Part II provides a description of present law. Part III describes current legislative proposals relating to pension portability, and Part IV is an analysis of related issues.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Proposals and Issues Relating to the Portability of Pension Plan Benefits* (JCS-11-88), July 11, 1988.

I. OVERVIEW

There is no precise definition of portability of pension benefits, and the term is often used to refer to a broad range of concepts. In general terms, portability refers to the ability to maintain pension benefits following a change in employment. Individuals who work for several employers may have lower pension benefits than individuals who work for only one employer for a variety of reasons, for example, because the individual did not work for any employer long enough to be vested, because a new employer does not maintain as generous a plan as a prior employer, or because service for the prior employer does not count as service under the new employer's plan. An individual may also lose pension benefits upon a job change because the individual spends a distribution of his or her accumulated pension benefit rather than saving the benefit for retirement. Pension portability proposals are designed to ameliorate the effects of employment changes on pension benefits.

In order to evaluate any pension portability proposal, it is helpful to understand what is meant by portability, and what aspect of portability any particular proposal means to address. The most-discussed concepts of portability generally fall into three categories: (1) portability of benefits, (2) portability of service (also sometimes called portability of credited service or portability of service history), and (3) portability of assets (also sometimes called portability of current or present value).

Portability of benefits

Portability of benefits generally refers to vesting. Vesting determines what portion of the individual's benefits the individual has a right to. If an individual is vested in some or all of his or her benefits, then the individual has a right to those benefits. If the individual is not fully or partially vested, then all benefits earned up to the time of termination of employment are forfeited.

Portability of benefits has also been used to refer to coverage (i.e., whether an individual is covered under a retirement plan) and differences between retirement plans. These issues often arise in discussions of portability because an individual who is covered by a retirement plan will be worse off if he or she changes jobs and the new employer does not have a plan or has a plan that does not provide as high a level of benefits. Coverage and comparability of benefits are really broader issues, however; an individual may remain at the same job throughout his or her working life and never earn a pension because the employer does not maintain a plan, or may not earn an adequate pension because of the design of the plan. These problems may be inherent in a voluntary private pension system.

Portability of service

Portability of service refers to the ability to count years of service under a plan of a prior employer in determining the pension benefits under a plan of a new employer. If service is totally portable, then all prior service under any plan is taken into account both in determining whether an individual is vested and the amount of the individual's benefits.

Portability of service is particularly important in the case of defined benefit plans. A defined benefit plan is a plan that pays benefits in accordance with a benefit formula specified in the plan. In contrast, a defined contribution plan does not promise a particular level of benefits; the benefit is the participant's account balance.

A common type of defined benefit plan is a final average pay plan. A typical benefit formula for a final average pay plan is, for example, 1 percent x years of service x the average compensation for the most recent 5 years of service. Some plans will base average compensation on the highest years of compensation, for example, the 5 years in the last 10 years in which the individual's compensation was the highest. If service is not portable, then the individual's benefits from a prior employer are based on compensation at the time of termination, rather than on the higher compensation that the individual will typically have in later years. Thus, the individual will have lower benefits if he or she works for several employers than the individual would have if he or she worked the same number of years for one employer.

Except for vesting, portability of service is not as great an issue in the case of defined contribution plans, because length of service typically is not as important in determining benefits. However, length of service is used to determine benefits in some types of defined contribution plans. Portability of service is more important in such cases. In addition, the effects of lack of portability are also not as great in the case of career average defined benefit plans. Such plans generally base benefits on compensation over the employee's working life, so that future pay increases do not have as great an effect on the overall level of benefits. Even in such cases, the lack of portability of service can cause the employee to lose valuable early retirement subsidies or similar benefits.

Portability of assets

Portability of assets refers to the ability to obtain a cash distribution of accumulated benefits and maintain those benefits in another retirement arrangement. Discussions of portability of assets also sometimes involves issues of preservation of benefits following a distribution. That is, whether the individual saves the benefit for retirement or uses the benefit for preretirement purposes.

Recent proposals on portability focus on portability of assets. The proposals seek to increase portability of assets by increasing the ability to keep pension benefits in a tax-favored retirement vehicle, such as an IRA, following termination of employment, for example, by requiring transfer to an IRA or another qualified plan, or expanding situations in which rollovers or transfers are permitted.

Some proposals also seek to increase the likelihood that pension benefits will be saved for retirement by restricting preretirement distributions. Some also address the broader issue of coverage, primarily by modifying the rules relating to simplified employee pensions (SEPs), particularly the rules relating to the availability of salary reduction SEPs.

II. PRESENT LAW

Under present law, the pension system that provides the greatest degree of portability is the social security system. The social security system provides almost universal coverage for all workers, and benefits are based on all covered employment. Outside the social security system (i.e., in the private pension system), present law requires portability of service in limited circumstances. There are a number of provisions in present law which facilitate portability of assets, the most significant being the ability to roll over distributions to an IRA. In addition, the withdrawal restrictions applicable to tax-qualified retirement plans, as well as the rules regarding taxation of benefits, are generally designed to provide incentives to individuals to save pension benefits for retirement purposes, and not spend them for preretirement uses.

A. Portability of Benefits

1. Social Security

In general

Social security, covering 93 percent of the Nation's workforce,[2] is currently the most portable pension system in the United States.[3] Under social security, covered workers earn benefits at each job and benefits are based on the worker's lifetime earnings. Thus, many of the problems sought to be addressed by portable pension proposals are addressed by the social security system.

In general, social security pays benefits to covered employees who have worked a required period. Benefits may also be payable to a covered worker's spouse and dependents.

In order to be covered under social security, an individual must receive wages and work in covered employment. Wages paid with respect to covered employment form the basis for determining the amount of benefits payable, and also are the base for determining the taxes used to fund social security benefits. Such taxes are paid under the Federal Insurance Contributions Act (FICA). FICA imposes both an employee-level tax, which is withheld from wage payments, and an employer-level tax, which matches the employee tax.

Self-employed persons are also generally covered by social security. Self-employed persons are not subject to the employee or em-

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[2] Committee on Ways and Means, U.S. House of Representatives, *Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means 1988 Edition* (March 24, 1988) p. 3.

[3] This discussion is limited to benefits provided under the Old-Age and Survivors Insurance (OASI) program. Related benefits are also provided under the Disability Insurance (DI) program and the Hospital Insurance (HI or Medicare) program. For a more complete discussion of these benefits, see Committee on Ways and Means, U.S. House of Representatives, *Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means 1988 Edition* (March 24, 1988).

ployer portion of the FICA tax, but instead are subject to taxes under the Self-Employment Contributions Act (SECA). The SECA tax is currently less than the total employee and employer FICA taxes, but will be comparable beginning in 1990.

Covered employment

Nearly all employment is covered employment under social security, with some exceptions. Federal Government employees hired before January 1, 1984, are not covered by social security. State and local government units elect whether or not to join the social security system. Certain other miscellaneous types of service are also excluded from the definition of covered employment, for example, service performed by a child under the age of 18 for a parent, service by an individual covered by the railroad retirement system, and certain domestic service performed by certain relatives.[4]

The trend in recent years has been to expand the definition of covered employment and, therefore, the classes of employees covered by social security. For example, coverage of Federal Government employees is required for employees hired after December 31, 1983. State and local governments that elect to be covered under social security could, prior to 1983, elect to terminate coverage. Such withdrawal from the social security system is no longer permitted. Employees of religious, charitable, educational, and certain other tax-exempt organizations used to be covered by social security only if the organization filed a notice with the Internal Revenue Service agreeing to such coverage. Beginning in 1984, all employees of tax-exempt employers are covered by social security.

Covered wages

In general, the definition of wages for social security purposes includes all remuneration for employment below the social security wage base (including the cash value of remuneration not paid in the form of cash). For 1988, the taxable wage base is $45,000. There are a number of exceptions to this all-inclusive rule. For example, payments to or from a qualified plan and certain disability payments are not considered wages for social security purposes.[5]

As with the definition of covered employment, the trend has been to expand the definition of wages, thus expanding coverage, as well as the funding base for social security benefits. For example, generally effective for remuneration paid after December 31, 1983, elective deferrals under a qualified cash or deferred arrangement (i.e., a sec. 401(k) plan) are considered wages. Similarly, the Omnibus Reconciliation Act of 1987 expanded the definition of wages in a number of ways, such as by including cash tips as wages.

Vesting

In general, entitlement to social security benefits is based on quarters of coverage. The maximum number of quarters required for benefits is 40. The number of required quarters may be less, depending on the particular benefit and the age of the individual.

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[4] For a complete list of excluded service, see sec. 3121(b).
[5] For a complete list of excluded items, see sec. 3121(a).

The 40-quarter requirement is being phased in over time, and will be fully phased in for individuals who reach 62 in 1991 or later.

The requirement of 40 quarters of coverage to earn a benefit (i.e., 10 years of service) is longer than that currently required under most private sector retirement plans, and longer than the new vesting schedules that will go into effect in 1989 under the Tax Reform Act of 1986 (see discussion below). Nonetheless, it is much easier for an individual to accumulate the required service under social security because all covered employment with any employer is taken into account. Thus, the problem that exists under private pension plans, that an employee may switch jobs without becoming vested and lose credit for prior service, is not as prevalent in the social security system. Nearly all employees with significant work history are able to accumulate a benefit under social security.

2. Overview of Qualified Plans, SEPs

Under a plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan), an employer is allowed a deduction for contributions (within limits) to a trust to provide employee benefits. Similar rules apply to plans funded with annuity contracts. A qualified plan may be a pension, profit-sharing, or stock bonus plan.

An employer's deductions and an employee's benefits under a qualified plan may be limited by reference to the employee's compensation. The Code also imposes overall limits on benefits or contributions that may be provided under qualified plans.

Under a qualified plan, employees do not include benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred.

In addition, employees may make after-tax contributions to a qualified plan and defer taxation on the earnings on such contributions until distribution from the plan. An employee may also make elective deferrals to a qualified plan on a salary reduction basis. Elective deferrals are excludable from gross income when made, and are not taxed until distributed from the plan.

Benefits or contributions under a qualified plan are subject to standards designed to prohibit discrimination in favor of highly compensated employees. In addition, qualified plans are required to meet minimum standards relating to coverage (what employees participate in the plan), vesting (the time at which an employee's benefit becomes nonforfeitable), and benefit accrual (the rate at which an employee earns a benefit). Also, minimum funding standards apply to the rate at which employer contributions are required to be made under certain types of plans to ensure the solvency of pension plans.

A simplified employee pension (SEP) is another type of tax-favored retirement arrangement. Under a SEP, the employer contributes directly to an IRA established for the employee. A contribution must be made for an employee for a year if the employee is at

least age 21, has performed service during at least 3 of the immediately preceding 5 years, and received at least $300 of compensation from the employer for the year. Contributions must bear a uniform relationship to compensation. Under the Tax Reform Act of 1986, employers with less than 25 employees may establish SEPs on a salary reduction basis. Like qualified plans, contributions to SEPs are excludable from income and earnings accumulate on a tax-deferred basis.

3. Vesting Under Qualified Plans

In general

Under the Tax Reform Act of 1986, for plan years starting after 1988, a qualified plan must satisfy one of two faster vesting schedules. One permissible vesting schedule is 5-year cliff vesting, under which participants are fully vested after 5 years of service, but are not required to be vested before then. Alternatively, a plan may provide a graduated vesting schedule beginning with 20 percent vesting after 3 years of service and increasing to 100 percent after 7 years of service. A plan may provide for faster vesting than the required minimum.

Prior to the effective date of the Tax Reform Act vesting rules, employer contributions under qualified plans are generally required to vest under one of three schedules. The three permissible schedules are (1) 10-year cliff vesting, which requires that a plan participant be vested upon completion of 10 years of service, but requires no vesting prior to that time; (2) 5-to-15-year vesting, which provides for graduated vesting between 5 and 15 years of service, that is, a participant is partially vested after 5 years of service and the percentage of vesting increases each year until the participant is fully vested after 15 years of service; and (3) rule-of-45 vesting, which provides graduated vesting depending on the participant's age and years of service. Under rule-of-45 vesting, it may take as long as 15 years for a plan participant to become fully vested.

Multiemployer plans

The Tax Reform Act vesting rules do not apply to multiemployer plans. A multiemployer plan is a plan to which more than one employer contributes pursuant to collective bargaining agreements. Multiemployer plans typically operate on an industry-wide basis. Multiemployer plans must provide for vesting at least as rapid as 10-year cliff vesting.

Under a multiemployer plan, participants generally earn credit for service with any employer that contributes to the plan. It is sometimes argued that longer vesting schedules are appropriate for multiemployer plans because this feature allows a participant to continue to earn service after switching jobs and, thus, allows participants who change employment to become vested in situations where they would not become vested if they participated in a plan maintained by a single employer.

Top-heavy plans

A special vesting schedule applies to top-heavy plans. In general terms, a top-heavy plan is a plan in which a high percentage of the

benefits are provided to "key employees." Key employees include certain owners and officers of the employer and certain highly compensated individuals. A top-heavy plan must provide either 3-year cliff vesting or graduated vesting between 2 and 6 years of service (20 percent per year of service).

Employee contributions, salary reduction contributions

Employee contributions and salary reduction contributions to a qualified cash or deferred arrangement (i.e., a sec. 401(k) plan) are required to be fully vested and nonforfeitable at all times.

4. Coverage

Other than social security, present law does not require an employer to provide retirement benefits for its employees. Present law provides tax benefits with respect to qualified plans with the intent that these benefits will be sufficient incentive for employers to establish retirement plans. If an employer does establish a qualified plan, then present law imposes coverage and nondiscrimination requirements that are designed to ensure that the plan benefits rank-and-file employees as well as highly compensated employees.

Under present law, a plan is not qualified unless the plan satisfies at least one of the following coverage requirements: (1) the plan benefits at least 70 percent of all nonhighly compensated employees (the "percentage test"), (2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan (the "ratio test"), or (3) the plan meets the average benefits test. A plan meets the average benefits test if (1) the plan benefits such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated employees, and (2) the average benefit percentage for nonhighly compensated employees of the employer is at least 70 percent of the average benefit percentage for highly compensated employees of the employer.

In addition, a plan generally cannot require as a condition of participation that an employee complete a period of service extending beyond the later of (1) the date on which the employee attains age 21, or (2) the date on which the employee completes 1 year of service.

As noted above, a separate coverage rule applies to SEPs. Under a SEP, a contribution must be made for an employee for a year if the employee is at least age 21, has performed service during at least 3 of the immediately preceding 5 years, and received at least $300 of the compensation from the employer for the year.

B. Portability of Service

Present law does not generally require portability of service. That is, when an individual changes employers, service with the old employer generally is not required to be taken into account in determining benefits under the new employer's plan.

Present law does provide for some portability of service in the case of related employers. For this purpose, related employers include corporations under common control, trades or businesses

(whether or not incorporated) under common control, and certain affiliated service groups. Control is generally defined as 80 percent ownership.

For purposes of the minimum vesting requirements, service with all related employers is taken into acccount. For example, if an individual working for one company is transferred to a related company, then service with the first company is generally required to be taken into account in determining whether the individual is vested under the plan of the new employer.

On the other hand, service with related companies is not required to be taken into account in determining years of participation for purposes of calculating an employee's benefit. Thus, if an employee transfers to a related company that maintains a different plan than his or her original employer, the benefits under the new plan need only be based on service with the new employer. Although tacking of service is not required in such cases, as a matter of practice, some employers will take into account all service with members of the controlled group.

Present law also provides that, in the case of an employer that maintains a plan of a predecessor employer, service for the predecessor is treated as service for the employer. In addition, in the case of an employer maintaining a plan which is not the plan maintained by a predecessor employer, service with the predecessor is treated as service for the employer to the extent required by regulations.

The predecessor employer rule could result in some portability of service in a number of situations, particularly in the case of corporate mergers and acquisitions and similar transactions. However, there are as yet no regulations defining predecessor employer or otherwise interpreting the provision, so that the scope of the provision is unclear.

Multiemployer plans often provide portability of service. Such plans typically provide that an employee earns benefits as long as the employee works for any participating employer. Thus, employees can change jobs among participating employers without interrupting benefit accrual. Such portability is not mandated by law, however, and the extent to which service with participating employers is taken into acccount may differ from plan to plan.

C. Portability of Assets

1. In General

There are a number of provisions in present law that facilitate portability of assets. Present law encourages portability by permitting assets to be rolled over or to be transferred from one tax-favored retirement arrangement to another, and by providing incentives to individuals to save amounts received from retirement plans for retirement purposes.

2. IRA Rollovers and Transfers

An individual may generally roll over a distribution received from a qualified plan to an IRA if (1) the distribution is a total distribution of the individual's entire interest in the plan, or (2) the

distribution is a qualified partial distribution of the individual's interest in the plan. To the extent a distribution is rolled over into an IRA, it is not includible in income and is not subject to the 10-percent additional income tax on early distributions (see below). Of course, when such amounts are subsequently distributed from the IRA, they are includible in income and subject to the 10-percent additional income tax unless an exception to the tax applies.

A total distribution may be rolled over to an IRA if it is made (1) because of the death of the individual, (2) after the individual has attained age 59½, (3) because of termination of employment (other than in the case of a self-employed person), or (4) in the case of self-employed persons only, after the individual becomes permanently disabled. In the case of these distributions, a distribution is a total distribution only if it includes the individual's complete share in all of the employer's pension plans, or profit-sharing plans, or stock bonus plans. That is, for this purpose, all plans of the same type are treated as a single plan. A total distribution may also be rolled over if it is made because of a termination of a plan. In order to qualify as a partial distribution, a distribution must be at least 50 percent of the individual's interest in the plan and meet certain other requirements.

Only employer contributions (and income on employer or employee contributions) may be rolled over to an IRA. Distributions of employee contributions cannot be rolled over.

Tax-free rollovers and transfers between IRAs are permitted, although certain restrictions may apply.

3. Rollovers and Transfers to Another Qualified Plan

Distributions from qualified retirement plans can generally be rolled over to another qualified plan or transferred to another qualified plan on the same basis that distributions can be rolled over to an IRA, except that partial distributions may only be rolled over to an IRA. Present law does not require that plans permit transfers or rollovers from another qualified plan. Plan provisions permitting such transactions are likely to be most prevalent in the case of related companies or where there has been a merger or acquisition.

4. Incentives to Retain Funds for Retirement Purposes

Withdrawal rules

In some cases, present law restricts the ability of employees to obtain a distribution from a qualified retirement plan prior to termination of employment. In the case of pension plans, i.e., defined benefit plans and money purchase pension plans, distributions cannot be made prior to termination of employment. Elective contributions to qualified cash or deferred arrangements (sec. 401(k) plans) cannot be distributed prior to termination of employment, attainment of age 59½, death, disability, or financial hardship. Contributions to profit-sharing and stock bonus plans generally can be distributed within 2 years of when they were contributed. Employee contributions generally may be withdrawn at any time. A

plan could impose stricter restrictions on plan distributions than those imposed by law.

The qualification rules generally require that a distribution be available upon the attainment of normal retirement age. Whether an employee who terminates employment prior to normal retirement age has the right to obtain a current distribution of the value of his or her benefit depends on the terms of the plan. Defined contribution plans generally permit a distribution of the employee's account balance upon termination of employment. In defined benefit plans, there are not separate accounts for each individual and, as a result, distributions often are not available until retirement age. Some employers prefer not to make lump-sum distributions available from their defined benefit plans, because doing so can affect the funded status of the plan.

If the present value of the employee's benefit does not exceed $3,500, the benefit may be distributed upon termination of employment to the individual without the individual's consent. Many plans, including both defined contribution plans and defined benefit plans, will cash out benefits of less than $3,500 because the employer will want to avoid the administrative burdens of keeping track of small benefits for former employees.

If the present value of the individual's benefit exceeds $3,500, then the benefit cannot be distributed prior to the later of normal retirement age or age 62, unless the participant consents to the distribution. Thus, participants with larger benefits have the option of deferring a plan distribution until retirement age. Leaving the benefits in the plan may be more beneficial than obtaining a distribution. For example, it would make it more likely that the individual would not spend the benefit prior to retirement. In addition, the rate of return under the plan may be greater than the rate of return available outside the plan.

Taxation of distributions

A number of rules regarding taxation of distributions are designed to encourage individuals to save distributions for retirement purposes rather than use them for current consumption. For example, the Tax Reform Act of 1986 added a 10-percent additional income tax on all early distributions from qualified retirement plans, including IRAs. Prior to the Reform Act, a similar 10-percent tax applied to early distribution from IRAs and early distributions to certain "key employees," such as 5-percent owners, from a qualified plan.

The tax is an additional income tax, so it only applies to the portion of a distribution includible in income. Thus, the tax does not apply to distributions of employee contributions or to the portion of a distribution that is rolled over to another qualified plan or an IRA.

In addition, the additional tax does not apply to distributions (1) after attainment of age 59½; (2) due to the death of the individual; (3) due to the disability of the individual; (4) used to pay medical expenses that would be deductible if the individual itemized deductions (not applicable to IRAs); (5) that are part of a series of substantially equal periodic payments made for the life or life expectancy of the individual (or the joint lives or joint life expectancies of

the individual and his or her spouse); (6) made in the case of an employee who separated from service after attainment of age 55 (not applicable to IRAs); (7) from an employee stock ownership plan; or (8) made pursuant to a qualified domestic relations order (not applicable to IRAs).

Other changes in the Tax Reform Act were also designed to reduce the incentive to take distributions prior to retirement. Under the law prior to the Tax Reform Act, an individual who received a lump-sum distribution could elect to apply 10-year income averaging to the distribution, which treated the distribution as if it had been received over a 10-year period. In addition, under prior law, the portion of a lump-sum distribution attributable to contributions prior to January 1, 1974, could qualify for treatment as long-term capital gains.

The Tax Reform Act phased out long-term capital gain treatment over 6 years and replaced 10-year forward averaging with 5-year forward averaging. In addition, 5-year income averaging may be elected only after the individual has attained age 59½, and only one such election may be made.

In making these changes, Congress determined that the prior-law averaging provisions encouraged individuals to withdraw tax-favored funds from tax-favored retirement arrangements before retirement and were therefore inconsistent with the policy of providing income at retirement. The original purpose of the provisions was to mitigate the effects of the progressive income tax structure on individuals receiving all of their benefits in a single year. The same purpose is now served, however, by permitting individuals generally to roll over distributions into an IRA.

The Tax Reform Act also changed the rules relating to the treatment of basis (e.g., employee contributions) when an individual receives a distribution from a tax-favored retirement arrangement to which both employee and employer contributions have been made. Under prior law, if an amount was received before the annuity starting date (i.e., the date on which an amount was first received as an annuity), the individual was treated as first receiving the individual's own investment in the contract (basis), which was nontaxable, and then taxable income. The 1986 Tax Reform Act modified the basis recovery rules for pre-annuity starting date distributions to provide for the pro-rata recovery of basis. Thus, with respect to such a distribution, an individual is entitled to exclude an amount determined by multiplying the amount of the payment by the ratio of the individual's basis to the total value of the accrued benefit under the plan.

In making this change, Congress determined that the prior-law rule permitted the accelerated tax-free recovery of employee contributions and thus further encouraged the use of tax-favored retirement arrangements for nonretirement purposes.

III. DESCRIPTION OF LEGISLATIVE PROPOSALS

A. Pension Portability Act of 1988

(H.R. 1961[6]—Mr. Jeffords, Mr. Hawkins, Mrs. Roukema, and Mr. Clay)

Explanation of Provisions

In general

H.R. 1961, as reported by the House Committee on Education and Labor, would modify the rules relating to distributions from qualified plans (sec. 401(a)), qualified annuity plans (sec. 403(a)), tax-sheltered annuity contracts (sec. 403(b)), and individual retirement arrangements (IRAs) (sec. 408). Generally, the bill would provide that (1) in certain circumstances, direct transfers to IRAs are required in lieu of distributions; (2) the Secretary of the Treasury may permit the distribution of employee contributions to be rolled over; (3) distributions from IRAs must be made with the consent of the IRA owner; (4) certain spousal rights to survivor benefits are required for IRAs and tax-sheltered annuity contracts; (5) certain nontax provisions are made applicable to pension plans consisting of one or more IRAs; and (6) the rules relating to salary reduction SEPs are modified.

Transfers

In general, the bill would require that single-sum distributions to employees or their spouses from qualified plans, qualified annuity plans, and tax-sheltered annuity contracts (qualified retirement plans) be made in the form of a direct trustee-to-trustee transfer to an IRA. This requirement would not apply, however, if (1) the present value of the employee's accrued benefit exceeds $3,500; (2) a different form of benefit is elected; and (3) commencement of payment of the benefit is not deferred. This requirement also generally would not apply to governmental plans, church plans, certain frozen plans, and certain plans to which employers do not contribute.

The bill also would require that an individual be permitted to transfer IRA assets to another IRA or to a qualified retirement plan that accepts such transfers.

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[6] H.R. 1961 was referred jointly to the House Committees on Education and Labor and Ways and Means, and was reported, with amendments, by the Committee on Education and Labor on June 7, 1988 (H. Rpt. 100–676, Part 1). S 2343 (introduced by Senator Quayle) is the same as H.R. 1961 as reported.

Rollovers

Under the bill, the Secretary may permit distributions from qualified retirement plans of employee contributions to be rolled over to another such plan or to an IRA.

IRA distributions

Under the bill, certain assets in IRAs may not be distributed without consent of the IRA owner. The assets subject to this rule are assets transferred from a qualified retirement plan and assets in a SEP. An exception would be provided for distributions in the form of a 50-percent qualified joint and survivor annuity or a single life annuity to the extent that such distributions are required by the minimum distribution rules.

Spousal rights

Present law provides an individual with certain rights to survivor benefits with respect to his or her spouse's interest in qualified plan assets. The bill would extend these rights to IRAs and tax-sheltered annuity contracts by treating such arrangements as non-pension defined contribution plans. However, with respect to IRAs, such treatment would only apply to assets transferred from a qualified retirement plan and assets in a SEP.

IRA pension plans

The bill would provide that pension plans consisting of one or more IRAs are subject to certain requirements under Title 1 of ERISA. Generally, IRA pension plans are to be treated as other pension plans under Title 1, except that the funding rules do not apply and only certain rules under Part 2 (generally relating to participating and vesting) apply. In general, the rules applicable under Part 2 are (1) the participation rules (with special rules for SEPs); (2) the prohibition on alienation or assignment; and (3) the vesting rules (with the modification that all interests must be 100 percent vested).

Salary reduction SEPs

Under certain circumstances, the bill would allow employers to establish a new type of SEP that permits employees to reduce their salary and contribute the amount of such reduction to the SEP. This alternative arrangement would be available to employers (other than State or local governments or tax-exempt organizations) not otherwise maintaining a qualified plan or qualified annuity plan. Under the bill, such salary reduction SEPs would be subject to nondiscrimination rules that are similar to, but less restrictive than, the rules applicable under present law to salary reduction SEPs. The bill also would modify certain other nondiscrimination requirements for all SEPs, without regard to whether they allow salary reduction.

Effective Date

The bill would be effective for plan years and taxable years beginning after December 31, 1991.

B. Portable Pension Plan Act of 1987

(H.R. 1992 [7]—Mr. Feighan, Mr. Matsui, Mr. MacKay, Mr. Bates, Mr. Dymally, Mr. Towns, Mr. Rangel, Mr. Berman, Mr. Chandler, Mrs. Byron, Mr. Savage, Mr. Morrison, Mr. Murphy, Ms. Kaptur, Mr. Evans, Mr. Gray, Mr. Fauntroy, Mr. Wolpe, and Mr. Crockett)

Explanation Provisions

In general

In general, H.R. 1992 would provide that (1) the 10-percent early distribution tax (Code sec. 72(t)) is raised to 20 percent; (2) the exceptions to the early distribution tax are modified; (3) the distribution rules for qualified plans, SEPs, and eligible deferred compensation plans are modified to reduce the amount of preretirement distributions; (4) employers that do not maintain qualified plans must establish a salary reduction SEP on request by an employee; (5) salary reduction SEPs may be maintained by any employer; (6) salary reduction SEPs established by an employer must be available to all of the employer's employees, but no other nondiscrimination rules apply to such SEPs; (7) integration is impermissible for SEPs; (8) SEPs are subject to Title 1 of ERISA (with certain special provisions); (9) the Secretary of Labor is to help small employers in establishing plans; and (10) the Comptroller General is to study pension plan administration and portability.

Early distribution tax

The bill would modify the early distribution tax in several respects. First, it would raise the tax from 10 percent to 20 percent. Second, it would extend the exception for medical hardship to IRAs. Third, the bill would exempt from the tax distributions from a terminated defined benefit plan subject to Title IV of ERISA. The bill also would modify the exceptions for distributions after (1) age 59½, (2) early retirement after age 55, and (3) death. Under the bill, such exceptions would not apply unless the distributions are (1) made with spousal consent, or (2) made in a series of substantially equal periodic payments over the life or life expectancy of the participant or of the participant and his or her beneficiary. Further, the bill would eliminate the substantially equal periodic payment exception as an independent exception.

Distributions

Under the bill, qualified plans may not make an immediate distribution of any assets unless the distribution satisfies one of two

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[7] H.R. 1992 was referred jointly to the House Committees on Education and Labor and Ways and Means.

requirements: (1) the distribution is one that is exempt from the early distribution tax, or (2) the distribution is a transfer to a portability maintenance plan. A portability maintenance plan is defined as a qualified plan, SEP, or IRA, provided that the SEP or IRA is subject to the bill's distribution rules.

In addition, the bill would provide that if a participant separates from service prior to retirement and his or her vested employer benefit exceeds $3,500, the participant may require the plan to transfer his or her benefit to a portability maintenance plan. The plan may make such a transfer with respect to lesser benefits.

These distribution rules also would apply to SEPs and eligible deferred compensation plans (sec. 457). However, the rules would not apply to distributions of dividends for which the employer takes a deduction under section 404(k).

Salary reduction SEPs

Under the bill, any employer may maintain a salary reduction SEP. In addition, employers that have not maintained a qualified plan, qualified annuity plan, or tax-sheltered annuity contract for the past 5 years must establish a salary reduction SEP if requested to do so by any employee. The bill also exempts salary reduction SEPs from (1) all nondiscrimination rules other than the requirement that all employees be eligible to make salary reduction contributions, and (2) the limits on employer contributions. The bill further prohibits SEPs from using integration to satisfy the nondiscrimination rules applicable to contributions other than salary reduction contributions.

Title 1 of ERISA

The bill would provide that SEPs are pension plans for purposes of Title 1 of ERISA. However, SEPs would be subject to certain special rules: (1) the Secretary of Labor is to prescribe simplified rules for reporting and disclosure; (2) SEP assets must be 100 percent vested; (3) the applicable participation requirements are those imposed by the tax Code; and (4) there are no minimum funding rules.

Secretary of Labor

The Secretary of Labor would be required to take appropriate action, including dissemination of information, to facilitate the adoption of qualified plans by small employers. The Secretary is to report annually on his or her efforts, together with appropriate legislative recommendations.

Comptroller General

The Comptroller General would be required to conduct a study of qualified plan administration and portability and report the results of the study to Congress within a year of the date of enactment.

Effective Date

The bill generally would be effective for plan years beginning on or after January 1, 1988, with a delayed effective date for collectively bargained plans and a delayed date for plan amendments. The requirements with respect to the Secretary of Labor's efforts regarding small employers would be effective on enactment.

C. Other Proposal

(H.R. 2643 [8]—Mr. Chandler)

Explanation of Provisions

In general

In general, H.R. 2643 would provide that (1) defined contribution plans must accept rollover contributions; (2) qualified plans may not make distributions with respect to an employee before the employee has attained age 59½ (with an exception); (3) qualified plan distributions must be made over the life of the employee or less rapidly (with certain exceptions); (4) an employee who separates from service may require that his or her qualified plan benefit be transferred to another plan or IRA; (5) IRA assets attributable to transfers from qualified plans are subject to the rules of (2) and (3) above; and (6) the rules for salary reduction SEPs are modified in certain respects.

For purposes of the above rules, qualified annuity plans are treated like qualified plans.

Distribution rules

The bill would prohibit qualified plans from making distributions with respect to an employee before the employee attains age 59½. The bill also would require that distributions from a qualified plan be made over the life of the employee or less rapidly. These rules would not apply to those covered under the early retirement provisions of the Tax Reform Act of 1986. The rules also would not apply to certain distributions that are exempt from the early distribution tax (sec. 72(t)), direct transfers to another plan or IRA, or amounts used to pay for nursing home care or long-term care insurance. Under the exemption based on section 72(t), the rules would not apply to distributions (1) on or after the death of the employee, (2) attributable to the employee's disability, (3) after early retirement after age 55, (4) to the extent of deductible medical expenses, (5) from employee stock ownership plans (ESOPs) under certain circumstances, and (6) under qualified domestic relations orders (sec. 414(p)).

Transfers

Under the bill, a qualified plan must allow an employee who separates from service to transfer his or her benefit to another plan or IRA.

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[8] H.R. 2643 would only amend the Internal Revenue Code, and was referred to the House Committee on Ways and Means. S. 1349 (introduced by Senator McCain) is identical to H.R. 2643.

IRA distributions

The bill would provide that IRA assets attributable to a transfer from a qualified plan are subject to the distribution rules described above.

Rollover contributions

Under the bill, a defined contribution plan must accept rollover contributions from the employees of the sponsoring employer, provided that such contributions relate to a distribution from a qualified plan.

Salary reduction SEPs

The bill would provide that an employer (other than a State or local government or tax-exempt organization) of any size may maintain a salary reduction SEP if it does not maintain a qualified plan. In addition, the bill would require that an eligible employer establish a salary reduction SEP if any employee so requests.

Effective Date

The bill would be effective for years beginning after 1988, with a delayed effective date for collectively bargained plans.

IV. ISSUES AND ANALYSIS

The major focus of current legislative proposals is portability of pension plan assets. The proposals seek to increase portability of such assets by increasing the ability to keep pension benefits in a tax-favored retirement vehicle, such as an IRA, following termination of employment. Some proposals also increase the likelihood that pension benefits will be saved for retirement purposes by restricting preretirement distributions. Some proposals also address the broader issue of coverage, primarily by expanding SEPs, particularly the availability of salary reduction SEPs.

A. Portability of Benefits

1. Vesting

The current legislative proposals generally do not deal with portability of benefits, and generally do not require faster vesting.

The shorter vesting schedules of the Tax Reform Act should improve the ability of individuals who change jobs to earn a pension, because more employees will have the opportunity to become vested. However, the effect of the new vesting schedules will also depend on other factors, such as whether or not the individual saves the benefit until retirement or spends it, and the interest rate the individual earns on the benefits, if they are saved.

The Tax Reform Act vesting schedules may have more effect in the case of defined benefit plans than in the case of defined contribution plans. Although the legal requirements for such plans are the same, as a matter of practice, defined contribution plans frequently have shorter vesting schedules than defined benefit plans.

Of course, even with the new vesting schedules, it is still possible that many individuals will not remain long enough at a single job to become fully vested. This will be particularly true for industries with relatively high turnover rates. For this reason, some would argue that any portability proposal should require that all benefits be 100 percent vested at all times.

Employers might object to an immediate full vesting requirement. Full vesting could increase pension costs because employers typically use the benefits forfeited by nonvested employees to fund the benefits of other employees. This increase in pension costs could cause employers to reduce the level of benefits provided in the future. In addition, employers often use the promise of a pension to encourage employees to stay with the company for a number of years, and to reward long-service employees. An immediate vesting requirement could reduce the ability of employers to use pension plans for such purposes.

2. Coverage

A common approach to the coverage issue in various portability proposals is to expand the use of SEPs, particularly salary reduction SEPs. Some argue that it is appropriate to expand SEPs because they are relatively easy to administer, and therefore are more likely to be used by employers who are concerned about administrative costs and responsibilities. Salary reduction plans are likely to be attractive to employers who do not want to commit to making a certain amount of contributions each year, or who want to minimize pension costs.

Some would argue that if there is any expansion of SEPs (or any other tax-favored retirement arrangement), it is important not to relax nondiscrimination rules. Present-law rules are designed to ensure that rank-and-file employees, as well as highly compensated employees, actually benefit from a plan. Any relaxation of these rules would mean shifting tax-favored benefits more in favor of highly compensated employees.

Some would argue that encouraging broader use of elective tax-favored retirement plans, such as salary reduction plans, is not as likely to increase the overall level of retirement benefits as non-elective arrangements. They would argue that the individuals who are most likely to want to contribute to a plan on an elective basis, or who would contribute the most on an elective basis, are highly compensated employees who would save for retirement in any event. In order to expand coverage for less highly compensated employees, who tend to spend more currently rather than save, non-elective retirement arrangements should be encouraged.

There are other ways within the present-law retirement plan system to increase coverage. The present-law coverage rules applicable to qualified plans generally could be modified to require broader coverage.

Ultimately, some lack of coverage may be inherent in the present voluntary pension system. The present system uses the tax laws to provide an incentive for employers to establish retirement plans. Tax benefits are provided with respect to qualified plans with the intent that these benefits will be sufficient incentive for employers to establish plans. Nondiscrimination rules are designed to ensure that if an employer establishes a plan, it covers rank-and-file employees as well as highly compensated employees. Subject to the nondiscrimination rules and other qualification requirements, employers, together with employee representatives in the case of collectively bargained plans, decide whether to establish a retirement plan, what type of plan to establish, and what level of benefits to provide.

Such a voluntary system has its limits, as the tax benefits may not be sufficient incentive in some cases for employers to maintain any plan or an adequate plan. As long as maintaining a voluntary private pension system is considered an important policy objective, then some workers will have no or only a small employer-provided retirement benefit and will have to rely more heavily on social security and individual savings to provide retirement income.

Concern over the limitations of a voluntary system led to the development of a proposed minimum universal pension system

(MUPS) initially advanced by the 1981 President's Commission on Pension Policy. The Commission's proposal would have required employers to contribute 3 percent of compensation to a defined contribution plan on behalf of each employee over 25 with at least one year of service. Contributions would be 100 percent vested.

Those in favor of some type of MUPS argue that it would ensure a minimum benefit for all workers and provide a fully funded portable pension. On the other hand, critics argue that if a more expansive mandatory retirement system is desirable, it would be more efficient to expand the social security system rather than establish an entirely new system to supplement social security.

B. Portability of Service

The current portability proposals do not address the issue of portability of service. Thus, these proposals may not significantly benefit individuals in plans which base benefits on length of service, such as defined benefit plans.

Requiring portability of service could be administratively difficult. Records of an employee's service with all employers would be required. In addition, pension costs for a new employer could be increased because benefits would be based on service with a prior employer. One possible solution to this problem would be to require, as a condition of counting prior service under a new plan, that assets be transferred from the old plan to cover the benefit from the old plan. The administrative problems that would need to be addressed to ensure a fair portability system could be one reason why recent proposals do not address this issue.

C. Portability of Assets

The current legislative proposals focus on increasing the portability of assets. Many of the proposals would have that effect, by expanding the ability to retain pension funds in tax-favored arrangements following termination of employment and restricting preretirement withdrawals from tax-favored arrangements. Such proposals are consistent with the policy objective that the funds should be used for retirement purposes.

Some have argued that there should be a Federal clearinghouse for retirement benefits in order to facilitate portability. In the bill that became ERISA in 1974, the Senate passed a provision establishing a clearinghouse that would have been administered by the Pension Benefit Guaranty Corporation (PBGC) and would have accepted transfers of lump-sum distributions from qualified plans. Such transfers would have been made only if the employer maintaining the plan and the employee agreed to the transfer. The concept of a clearinghouse was also included as part of the 1981 President's Commission on Pension Policy MUPS proposals.

Those in favor of a clearinghouse argue that it would ease administration of a portable pension system by providing a central administrative agency. Opponents of the idea argue that it would be costly and unnecessary to establish a new agency for this purpose, or further burden existing agencies.

Some employers and employees may object to further restrictions on preretirement distributions. Employers often like to have design

flexibility in order to tailor a plan to the needs and desires of employees. Employees also may want to be able to obtain funds prior to retirement to use for nonretirement purposes or in the case of financial hardship.

Some of the proposals require that distributions be transferred directly to an IRA, or that transfer is possible without complying with the spousal consent and distribution rules currently applicable to qualified plans. Such proposals also generally extend the consent and distribution rules to IRAs. While such an extension protects the rights of the spouse in an IRA, it might be objected to by IRA trustees and custodians because it will require additional administrative responsibilities.

Some proposals also permit employee contributions to be rolled over or transferred to an IRA. In some cases, the individual may have made significant contributions to the pension plan maintained by the employer, and some would argue that rollovers of employee contributions should be permitted in order to permit interest to continue to accumulate on a tax deferred basis on what could be a substantial part of an individual's retirement savings.

One reason for prohibiting rollovers of employee contributions to an IRA is that it can create administrative problems for IRA trustees and the Internal Revenue Service. If such contributions are rolled over, it is necessary to keep track of such contributions, which have already been taxed and therefore are not subject to tax again upon distribution, separately from other IRA contributions, which have not previously been taxed and are taxable upon distribution.

Some argue that much of the administrative burdens associated with rollovers of employee contributions have been eliminated due to the Tax Reform Act. The Tax Reform Act allows individuals to make both deductible and nondeductible contributions to IRAs. Thus, under the Tax Reform Act, there is a system in place to distinguish between previously taxed and previously untaxed IRA contributions. On the other hand, the Tax Reform Act rules have been in effect only since the end of 1986, and therefore the adequacy of such rules arguably has not yet been fully tested.

Another possible objection to permitting rollovers of employee contributions is that it could tend to favor more highly compensated individuals. The ability to defer taxation by making employee contributions to a qualified plan is more attractive to highly compensated employees than less well-compensated employees. Prior to the Tax Reform Act, there were no significant restrictions, such as nondiscrimination rules, applicable to employee contributions. The Tax Reform Act added nondiscrimination rules effective beginning in 1987. The lack of nondiscrimination rules prior to 1987 means that highly compensated individuals may tend to have made greater employee contributions and that they will benefit more from permitting rollovers of employee contributions. As the nondiscrimination rules have been in effect longer, the less highly compensated individuals may benefit more.

Some would argue that the current legislative proposals are beneficial because they increase portability over the degree of portability available under present law. Others, however, would argue that the current proposals do not significantly address all the issues associated with portability (such as portability of service), and that broader legislation is necessary to have more complete portability.

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